

**ANALYSIS OF ORIGINAL BILL**Author: Correa Analyst: Marion Mann DeJong Bill Number: AB 2365Related Bills: See Legislative History Telephone: 845-6979 Introduced Date: 02/19/2004Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_**SUBJECT:** Employer Hiring Qualified Employee Credit/Manufacturing Trade or Business**SUMMARY**

This bill would create a manufacturing jobs credit.

**PURPOSE OF THE BILL**

According to the author's staff, the purpose of this bill is to provide an incentive for manufacturing companies to create new jobs in California.

**EFFECTIVE/OPERATIVE DATE**

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2004. The bill specifies that the credit would apply to taxable years beginning on or after January 1, 2004, and before January 1, 2009.

**POSITION**

Pending.

**Summary of Suggested Amendments**

Amendments are needed to resolve the department's implementation concerns. Department staff is available to assist the author with any necessary amendments. Please see "Implementation Considerations" below. In addition, amendments to resolve the concerns listed under "Technical Considerations" are attached.

**ANALYSIS**FEDERAL/STATE LAW

Current federal and state laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business. For example, an employer would be allowed a deduction for wages and benefits paid to employees.

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

4/5/04

Under federal law, employers located in an empowerment zone are allowed a 20% wage credit on the first \$15,000 of annual wages paid to residents of the zone. Employers located in renewal community zones are allowed a 15% wage credit on the first \$10,000 of annual wages paid to residents of the renewal community zone.

Existing state law provides a hiring credit for taxpayers conducting business activities within an Enterprise Zone (EZ), Local Agency Military Base Recovery Area (LAMBRA), Targeted Tax Area (TTA), and a Manufacturing Enhancement Area (MEA), collectively known as Economic Development Areas (EDAs). A qualified employee must be hired after the area is designated an EDA and meet certain other criteria. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax imposed on the EDA income.

### THIS BILL

This bill would create a credit for manufacturers that increase the number of manufacturing jobs in California. The credit would be equal to \$1,000 per qualified employee if the employee were paid at least twice the California minimum wage (\$13.50 per hour) and \$1,500 per qualified employee if the employee were paid at least three times the California minimum wage (\$20.25 per hour).

To be eligible for the credit, taxpayers must meet all of the following requirements:

- Be engaged in a manufacturing line of business as described in Codes 311 to 339 of the North American Industry Classification System (NAICS).
- Create a net increase in manufacturing jobs in California during the taxable year.
- Pay at least twice the California minimum wage (currently \$6.75) to each qualified employee.
- Pay some or all of the qualified employee's health care insurance.

Taxpayers must obtain certification that they are eligible for the credit from either the Employment Development Department (EDD), or a local agency as appropriate. EDD could provide preliminary screening and referral to a certifying agency, and is required to develop a form for this purpose. The taxpayer must retain the certification and provide it to the Franchise Tax Board if requested.

A qualified employee would mean an individual who meets all of the following:

- Is hired by the taxpayer on or after January 1, 2004, and before January 1, 2009.
- His or her services during the taxable year are directly related to the taxpayer's trade or business.
- He or she is employed with the taxpayer for at least 270 days. This test would be met if the termination of the employee within the first 270 days were:
  - voluntary on the part of the employee;
  - caused by the employee becoming disabled; or
  - due to certain defined employee misconduct.

In the case of a pass-through entity, the determination of whether a taxpayer qualifies for the credit would be made at the entity level. The credit would be allowed to the pass-through entity and passed through to the partners or shareholders.

All employees of businesses that are under common control or members of the same controlled group of corporations would be treated as employed by a single taxpayer. This would prevent controlled groups of taxpayers from transferring employees between members to trigger or increase the credit.

If a major portion of a business is acquired from another employer, the employment relationship between the employee and the new employer would be treated the same as the employment relationship between the employee and the prior employer. The new employer would "step into the shoes" of the old employer for purposes of qualifying for future credits.

Credit amounts in excess of tax liability could be carried forward and applied against tax liability in future years until the credit is used.

### IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

- This bill uses NAICS codes for determining whether a taxpayer is eligible for the credit. It is unclear what happens to a corporation that has a division in the described code but predominately does business in another corporate division in an activity code that does not qualify. It is unclear whether the NAICS codes are to be applied at the entity level or by corporate division. Also, clarification is needed regarding whether an entity's trade or business activity must actually be **classified** under NAICS as engaged in the line of business described in the manual, or whether the taxpayer merely needs to identify an activity described in a qualifying section of the manual to be a qualified taxpayer. Although the department administered similar business activity codes in the Manufacturers' Investment Credit, there were several implementation issues that evolved into disputes between taxpayers and the department, particularly in situations where a taxpayer was engaged in one activity that was unqualified but was successfully able to argue that an ancillary activity that was qualified more properly described their business activity. Since this bill uses the same statutory language formulation as the Manufacturers' Investment Credit on this particular issue, similar issues may arise if these provisions are not clarified.
- This bill uses NAICS codes 311 to 339, inclusive. The NAICS uses a code system with two to six digits. NAICS code 399 is just the beginning of a long list of Miscellaneous Manufacturing sub-sectors with the last code being 339999. Disputes may arise with taxpayers that are in the Miscellaneous Manufacturing sub-sector but are not in code 399 regarding whether they are entitled to the credit.
- The bill does not specify which version of the NAICS manual to use. Currently there are two editions of the NAICS manual, the 1997 edition and the 2002 edition. Differences between the two editions, or future unannounced editions, could cause disputes between taxpayers and the department regarding whether a taxpayer is eligible for the credit.
- The bill provides a specified credit amount, based upon the amount of pay, for each year of the employee's employment. It is unclear whether this means that in the second year of employment the employee could qualify the taxpayer for a \$2,000 (\$1,000 x 2 years of employment) credit, or it means the credit is \$1,000 each year and may be claimed each year that the taxpayer employs the employee.

- Although the bill requires the employer to increase the number of manufacturing jobs in California, the bill does not specify the base period to use for comparison nor the method to use for calculating the increase in manufacturing jobs. Further, the bill literally requires the particular employer to increase the number of **all** manufacturing jobs in California in the specified industry codes, not just jobs in their own business activities, which would be an impossible standard for either taxpayers or the department to administer.
- The bill requires the employer to pay at least twice the California minimum wage and part of the employee's health care insurance. It is unclear whether these requirements must be met for the entire taxable year, on any day of the taxable year, or only on the last day of the taxable year. It is also unclear whether an employer would qualify if the employer offers to pay a portion of the employee's health care insurance but the employee declines the insurance (e.g., the employee is covered by a spouse's policy).
- The bill defines a qualified employee as an employee who provides services that are directly related to the conduct of the taxpayer's trade or business. However, the bill does not define "directly related," which could lead to disputes between taxpayers and the department regarding whether an employee would qualify for the credit. It is also unclear whether this requirement is designed to prevent non-manufacturing jobs of the qualified taxpayer (i.e., administrative, accounting, legal, or secretarial) from qualifying for this credit, or whether something else is intended.
- This bill does not limit the number of years for the carryover period. Without a limit the department would be required to retain the carryover on the tax forms indefinitely because presently the bill would allow an unlimited credit carryover period. Recent credits have been enacted with a carryover limitation since experience shows credits are typically used within eight years of being earned.

#### TECHNICAL CONSIDERATIONS

Amendments are provided to resolve the following technical concerns:

- The definition of qualified employee states the employee must meet "both of the following requirements," then lists three requirements. Amendments 1 and 4 would change "both" to "all."
- Amendment 2 would correct a reference to the credit in the Corporate Tax Law. The current reference was inadvertently copied from the targeted tax area hiring credit.
- Amendments 3 and 5 would delete an unnecessary reference. The reference was inadvertently copied from existing economic development area hiring credits that provides an exception for seasonal employees. The credit proposed by this bill does not have a special provision for seasonal employees like the other credits.

## LEGISLATIVE HISTORY

SB 1523 (Ashburn, 2003/2004) would create a new hiring credit for employers with fewer than 100 employees. The credit would be available to the employer for the first five years of the qualified employee's employment. SB 1523 is in the Senate Revenue and Taxation Committee.

SB 1876 (Alpert, 2003/2004) would create a new credit, the Living Wage Opportunity and Revitalization Credit, equal to an unspecified percentage of the increase in wages an employer pays to raise the employee's wage to a living wage. SB 1876 is in the Senate Revenue and Taxation Committee.

## OTHER STATES' INFORMATION

The laws of *Florida, Illinois, Massachusetts, Michigan, Minnesota, New Mexico, and New York* were reviewed because their tax laws are similar to California's income tax laws. Based on a limited review, none of these states have credits for hiring manufacturing employees. However, *Florida, Illinois, Minnesota, and New York* have economic development area wage-type credits.

*New Mexico* recently enacted a credit for new high-wage economic-based jobs. The credit is equal to 10% of wages paid to eligible employees. The maximum amount of credit per employee is \$12,000 a year for three years.

## FISCAL IMPACT

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs are expected to be minor.

## ECONOMIC IMPACT

### Revenue Estimate

The revenue effects of this proposal over the initial three-year period are projected to be as follows:

Fiscal Year Cash Flow Impact Enactment Assumed After 06/30/04 \$ Millions		
2004-05	2005-06	2006-07
- 160	- 310	- 420

This estimate does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

### Revenue Discussion

According to the California Statistical Abstract, there were more than 1.6 million employees in manufacturing in California in 2002. Based on an analysis of corporation sample data, it is estimated that approximately 2/3 of these employees work for businesses with increasing employment levels. Thus, about 1.1 million (1.6 million x 2/3) employees work for qualified businesses. Assuming that 20% of all employees are new hires in any given year, it is estimated that there will be about 220,000

(1.1 million x 20%) new hires working for qualified employers each year. Assuming that 70% of these employees receive wages of at least twice the minimum wage, there will be about 154,000 (220,000 x 70%) qualified employees. If the average credit per qualified employee is \$1,300, the total amount of credits available will be \$200 million. Assuming that employers can use only about 60% of these credits produces an estimated revenue loss of \$120 million in the 2004-05 fiscal year. In succeeding years, taxpayers will be able to claim a similar amount of credits for new hires, credits for all qualified employees hired in earlier years of the program that remain with the company, and carryover credits that were not used in the year generated. The losses presented in the table above are adjusted to represent fiscal year impacts.

## **ARGUMENTS/POLICY CONCERNS**

- This bill does not restrict the credit to employees who are employed within California (and are thus themselves subject to California tax on their earnings).
- Although the bill requires the employee's activities to be directly related to the conduct of the taxpayer's trade or business, it does not restrict the employee's activities to the taxpayer's manufacturing trade or business. If the taxpayer is conducting more than one type of trade or business, one of which is not a qualified manufacturing business, the credit could be claimed for employees that are unrelated to the manufacturing business.
- Because the bill does not specify a minimum amount of the health care insurance that must be paid by the employer, an employer that pays as little as \$1 of an employee's health care insurance would be eligible to claim the credit.
- This bill would allow taxpayers in certain circumstances to claim multiple tax benefits for the same wage expense. For example, employees employed within an economic development area could qualify the taxpayer for this credit, an economic development area hiring credit, and a business expense deduction for the wages.
- Conflicting tax policies result when a credit is provided for an item that is already deductible as a business expense (double tax benefit). On the other hand, making an adjustment to reduce the business expense in order to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy.

## **LEGISLATIVE STAFF CONTACT**

Marion Mann DeJong  
Franchise Tax Board  
845-6979  
[marion.dejong@ftb.ca.gov](mailto:marion.dejong@ftb.ca.gov)

Brian Putler  
Franchise Tax Board  
845-6333  
[brian.putler@ftb.ca.gov](mailto:brian.putler@ftb.ca.gov)

Analyst	Marion Mann DeJong
Telephone #	845-6979
Attorney	Patrick Kusiak

FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 2365  
As Introduced February 19, 2004

AMENDMENT 1

On page 3, line 25, delete "both" and insert:

all

AMENDMENT 2

On page 4, line 15, delete "(d) of Section 23634," and insert:

(f) of Section 23635

AMENDMENT 3

On page 4, line 21, delete "(other than subdivision (f))".

AMENDMENT 4

On page 6, line 4, delete "both" and insert:

all

AMENDMENT 5

On page 7, line 8, delete "(other than subdivision (f))".